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American Institute of Certified Public Accountants. Auditing Standards Division

In Our Opinion...

*The Newsletter of the AICPA Auditing Standards Division**

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IN THIS ISSUE...

ASB ISSUES NINE NEW STANDARDS

by Peg Fagan

The ASB has approved for issuance nine new Statements on Auditing Standards (SASs) developed to

- clarify the auditor's responsibility for fraud
- improve the planning and performance of audits
- improve auditor external communications, including providing early warning about possible business failure
- improve auditor internal communication

This article summarizes the key requirements of the new SASs and explains how existing standards are changed.

The New SASs The nine new SASs are effective for audits of financial statements for periods beginning on or after January 1, 1989 with two exceptions—SAS No. 58, *Reports on Audited Financial Statements*, is effective for reports issued on or after January 1, 1989, and SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* is effective for audits of financial statements for periods beginning on or after January 1, 1990. Auditors may, however, apply these new standards before the effective dates.

Clarify the Auditor's Responsibility for Fraud SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* which supersedes SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities* restates the auditor's responsibility for material errors and irregularities. SAS No. 16 required the auditor to plan the audit to search for material misstatements; the new standard creates a greater responsibility by obligating the auditor to design the audit to provide reasonable assurance of detecting material errors and irregularities.

A new illegal acts SAS supersedes SAS No. 17, *Illegal Acts by Clients* (January 1977). SAS No. 54, *Illegal Acts by Clients*, distinguishes the auditor's responsibility for violations of laws or governmental regulations that have a direct and material effect on line item amounts in financial statements from the auditor's responsibility for violations of other or indirect laws and regulations. The standard also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

SAS No. 53 and SAS No. 54 require the auditor to determine that the audit committee or its equivalent is informed about irregularities and illegal acts unless they are inconsequential. Both new standards also identify cases where the auditor may have a duty to report such matters outside the client, such as auditor changes reported on Form 8-K, inquiries from successor auditors.

Improving the Planning and Performance of Audits SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* supersedes AU section 320, "The Auditor's Study and Evaluation of Internal Control." The new standard expands the auditor's responsibility to consider internal controls when planning an audit. It also updates the guidance on the auditor's study and evaluation of internal control by incorporating the concepts of audit evidence and audit risk that evolved in audit practice and were established in auditing standards after section 320 was issued.

SAS No. 55 broadens the concept of internal control to encompass three elements of the internal control structure; the control environment, the accounting system, and control procedures. The new standard requires the auditor to obtain an understanding of each of these elements sufficient to plan the audit. SAS No. 55 also requires the auditor to document this understanding of the internal control structure. After obtaining the understanding of the internal control structure, the auditor assesses control risk in relation to financial statement assertions.

SAS No. 56, *Analytical Procedures* requires auditors to use analytical procedures in the planning and reviewing stages of all audits. It also provides new guidance on designing, applying, and evaluating the results of analytical procedures. SAS No. 56 replaces SAS No. 23, *Analytical Review Procedures*.

SAS No. 57, *Auditing Accounting Estimates* was issued to help the auditor evaluate the reasonableness of accounting estimates. The new standard identifies internal control structure elements that may reduce the likelihood of material misstatements in estimates. It also describes procedures an auditor should consider in determining if management has identified all material accounting estimates and considered all key factors and assumptions relating to them.

*The views expressed herein are those of the authors and do not necessarily reflect the views of the American Institute of CPAs. Official positions of the AICPA are determined through certain specific committee procedures, due process, and deliberation.

ASB ISSUES NINE NEW STANDARDS *(continued from page 1)*

Improved Auditor Communications: External SAS No. 58, *Reports on Audited Financial Statements*, supersedes SAS No. 2, *Reports on Audited Financial Statements*. Furthermore, reporting guidance in other SASs, such as SAS No. 15, *Reports on Comparative Financial Statements*, has been incorporated in SAS No. 58 to aid practitioners in applying the new audit reporting standards. The most significant changes from the existing standard report, which had not been substantially modified since 1948, are:

- Adds an introductory paragraph that differentiates management's responsibility for the financial statements from the auditor's responsibility to express an opinion on the financial statements.
- Explains in the second—or scope—paragraph that an audit provides reasonable assurance within the context of materiality, about whether the financial statements are free of material misstatement.
- Adds a brief explanation in the scope paragraph of what an audit entails.
- Deletes from the opinion paragraph the reference to consistency.

Although the consistency reference is dropped from the new report, an explanatory paragraph should follow the opinion paragraph when accounting principles have not been consistently applied. SAS No. 58, together with SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, also changes the way auditors report on uncertainty (and substantial doubt about going concern). Both statements change existing standards by replacing the "subject to" opinion qualification with a required discussion of an uncertainty in an explanatory paragraph following the opinion paragraph.

SAS No. 59, which supersedes SAS No. 34, *The Auditor's Consideration When a Question Arises About an Entity's Continued Existence*, increases the auditor's responsibility for assessing going concern status by requiring the auditor to consider whether there is substantial doubt about the entity's ability to continue as a going concern in *all* audits.

The Statement also requires the auditor to include in his report an explanatory paragraph about the going concern uncertainty when there is substantial doubt about the entity's ability to continue as a going concern—even when that doubt does not affect asset recoverability and liability classification.

Internal Communications SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, which supersedes SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, requires the auditor to report significant deficiencies in the control environment, accounting system, and control procedures to management and the board of directors or audit committee. This responsibility is broader than that in SAS No. 20, which required the auditor to report material weaknesses in control procedures. The new standard also provides new guidelines for written reports on controls. The report has been revised to eliminate overly negative language.

SAS No. 61, *Communication with Audit Committees*, establishes a requirement for the auditor to determine that certain matters such as the initial selection of significant accounting policies and disagreements with management—are communicated to those who have responsibility for oversight of the financial reporting process. This standard is applicable to (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to an equivalent group, and (2) all Securities and Exchange Commission engagements as defined in note 1 to SAS No. 61.

CONCLUSION

Because CPAs have long accepted responsibilities to both preparers and users of audited financial information, the profession has a duty to continually assess auditing standards in light of the expectations of others. When such an assessment indicates a need to modify our standards, it is incumbent upon us to do so. Based on such an assessment and after due process, extensive deliberation and careful study, the ASB approved these nine new SASs. These new standards should bring the auditor's responsibility and performance and the public's expectations closer together.

DIVISION ISSUES NEW GUIDANCE ON MATTERS RELATING TO SOLVENCY

by Jane Mancino

Accountants have often provided solvency letters to lenders in connection with leveraged buyouts (LBOs), recapitalizations, and other secured financings. Such letters typically contain negative assurance about a prospective borrower's solvency after giving effect to the proposed transaction. Lenders ask for these letters because they are concerned that such financings may include a fraudulent transfer or conveyance under federal or state law.

A secured financing may include a fraudulent transfer or conveyance if the borrower receives less than a reasonably equivalent value for incurring the debt *and* one of the following is true:

- the borrower is insolvent at the time the debt is incurred or would be rendered insolvent thereby;
- by reason of incurring the debt the borrower would be left with unreasonably small capital; or
- by reason of the borrowing, the borrower would incur debts beyond its ability to pay as they mature

Since the loan proceeds in a typical LBO immediately pass from the borrower to a third party, such as its shareholders, the borrower has received less than a "reasonably equivalent value" for incurring the debt. If any of the above criteria is also met, the transaction may be deemed a fraudulent transfer; repayment obligations and the lender's security interest could then be set aside in favor of other creditors.

The statutes define significant matters relating to solvency in legal terms, not those used in generally accepted accounting principles. Whether these terms correlate with accounting terms such as market value, net realizable value, or net present value has never been determined. The statutes provide little guidance in applying these terms to complex situations.

The terms, definitions, and statutes of limitations under the federal and state statutes differ. Under the Federal Bankruptcy Code (the Code), assets should be at a fair valuation, while under some state statutes they should be at present fair saleable value. Some significant terms, such as unreasonably small capital, are not defined in the statutes. Under the Code, a transaction may be vulnerable for one year from the loan closing while, under some state statutes, a transaction may be vulnerable even if six years have elapsed.

DIVISION ISSUES NEW GUIDANCE ON MATTERS RELATING TO SOLVENCY *(continued from page 2)*

Reporting on Solvency, an Interpretation of SAS No. 26 issued in December 1984, provided guidance on solvency defined primarily with respect to the book values of assets less liabilities. As practice evolved, lenders provided definitions of solvency relating more closely to the legal definition, such as the appraised value of assets less liabilities and contingent liabilities.

The Auditing Standards Division has issued an interpretation of Statements on Standards for Attestation Engagements, *Attestation Standards*, stating that those standards preclude accountants from providing any form of assurance—through an examination, a review, or agreed-upon procedures—that an entity

- Is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby;
- Does not have unreasonably small capital;
- Has the ability to pay its debts as they mature.

In addition, accountants are precluded from providing any form of assurance on any financial presentation of matters relating to solvency.

Providing such assurance is precluded because these matters are legal concepts subject to varying legal interpretations not clearly defined in an accounting sense. Consequently, they do not provide the accountant with the reasonable criteria required to evaluate assertions about solvency under the third general attestation standard.

The interpretation also states that the attestation standards preclude accountants from providing assurance on equivalent or substitute terms for solvency, adequacy of capital, or ability to pay debts that have been defined and agreed upon by parties to the financing, for example, the term "fair saleable value of assets exceeds liabilities." Although these terms may be defined in the context of a particular engagement, experience has shown that use of the lender's definitions by the accountant could be misunderstood as assurance that a particular financing does not include a fraudulent conveyance or transfer. Further, those who are not aware that matters relating to solvency have been specifically defined for an engagement, may, as a result of learning that an accountant has issued a report on such matters, infer unwarranted assurance from such a report.

The interpretation notes that an accountant may perform various services under existing professional standards that may be useful to a client in connection with a financing. These services include:

- an audit or review of historical financial information,
- an examination or review of pro forma financial information,
- an examination or compilation of prospective financial information, or
- the application of agreed-upon procedures to historical, pro forma, or prospective financial information.

The interpretation provides reporting guidance for agreed-upon procedures reports issued in connection with a financing agreement. It also indicates that the report should make no reference to any solvency provisions in the financing agreement and should specifically disclaim any assurance on the borrower's solvency, adequacy of capital, and ability to pay debts. An illustrative agreed-upon procedures report is included in the interpretation.

The interpretation, which rescinds former interpretation *Reporting on Solvency*, AU section 9504.23–35, will be published in the May issue of the *Journal of Accountancy*. Members who need a copy of the guidance before then should contact Agnes Ramdas at 212/575–5517.

TECHNICAL PLAN HIGHLIGHTS

"EXPECTATION GAP" PROJECTS

In February 1987 the Auditing Standards Board issued exposure drafts of ten proposed standards. The Board has approved publication of nine new SASs, which will be available in May 1988. Each of these new standards is discussed in the article beginning on page 1.

The tenth exposure draft, the proposed attestation standard, *Examination of Management's Discussion and Analysis* (AICPA Staff: MIMI BLANCO). This proposed attestation standard would provide guidance to auditors engaged to attest to management's discussion and analysis (MD&A). *Schedule*: The Board has deferred further work on this proposed standard pending the SEC's decision on its concept release on MD&A. The Board expects to finalize the standard in 1988.

OTHER PROJECTS

Here is a summary of the status of the Auditing Standards Division's other projects.

Financial Forecasts and Projections (MIMI BLANCO). The Auditing Standards Board created the Forecasts and Projections Task Force to deal with problems encountered in implementing the guidance in the Statement on Standards for Accountant's Services on Prospective Financial Statements. Persons with questions or problems in this area are urged to write to the task force. The address is: AICPA, Auditing Standards Division, File 2660, 1211 Avenue of the Americas, New York, NY 10036–8775

Reporting on Pro Forma Financial Information (JANE MANCINO). The Board has voted to ballot an attestation standard that provides guidance in reporting on pro forma financial information. The Board also voted to limit the level of assurance given on the pro forma financial information to that given on the underlying historical financial information. *Schedule*: Standard to be issued second quarter 1988.

Omnibus SAS–1987 (MARK BEASLEY). The Board has approved final publication of SAS No. 52, *Omnibus Statement on Auditing Standards–1987*. This SAS contains amendments to SAS No. 5, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report*. SAS No. 27, *Supplementary Information Required by the FASB*; and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. The amendments recognize the GASB's authority to establish (1) financial accounting principles for state and local governmental entities pursuant to Rule 203 of the AICPA's Code of Professional Ethics and (2) standards on disclosure of financial information for such entities under Rule 204. It also revises existing standards in response to FASB Statement No. 89, *Financial Reporting and Changing Prices*. It rescinds SAS Nos. 28, *Supplementary Information on the Effects of Changing Prices*, SAS No. 40, *Supplementary Mineral Reserve Information*, and SAS No. 45, *Supplementary Oil and Gas Reserve Information*, with the guidance in SAS No. 45 being reissued as an auditing interpretation. *Schedule*: Final SAS to be available in May 1988.

Compliance Auditing (PATRICK MCNAMEE). The Board has approved issuance of an exposure draft of a proposed SAS that would provide guidance on the auditor's responsibility in an engagement to report on compliance with laws and regulatory requirements of government financial assistance programs. *Schedule*: Exposure draft expected to be available in May 1988. Comment deadline will be August 15, 1988.

TECHNICAL PLAN HIGHLIGHTS *(continued from page 3)*

Understanding Audits and the Auditor's Report, A Guide for Financial Statement Users (RAY JOHNSON). The auditing standards division is preparing an updated booklet to provide financial statement users with a nontechnical explanation of the meaning of the revised auditor's standard report. *Schedule*: The booklet will be available in the third quarter 1988.

Auditing Procedure Study: Audits of Small Businesses (RAY JOHNSON). The auditing procedure study *Audits of Small Businesses* is being revised to respond to the new SASs (52–61). The chapters on evaluating internal controls and on analytical review will be revised to discuss the implementation of SAS Nos. 55 and 56 in the small business audit. Other changes will be made throughout the study to provide guidance that is consistent with the new standards. *Schedule*: The revised auditing procedure study will be available in the third quarter 1988.

Revised Bank Confirmation Form (MARK BEASLEY). The Auditing Standards Board will consider the revision of the standard bank confirmation form and the issuance of an auditing interpretation explaining its use at its April 19–21, 1988 meeting. The Board will discuss (1) revising the standard bank confirmation to request information on deposits and loan balances only and (2) issuing an auditing interpretation to provide the auditor guidance on asking banks for information about other transactions. An article in the January 1988 *In Our Opinion* explains why the ASB undertook this project.

REPORTING ON GOVERNMENTAL DEPARTMENTS AND AGENCIES

The AICPA committee on governmental accounting and auditing has concluded that independent accountants may issue an unqualified opinion on the financial statements of a department or agency that constitutes less than a fund. The accountants' report should indicate that the statements present information for only a portion of the funds and account groups of a larger governmental reporting entity on a basis that conforms with generally accepted accounting principles. Here is the report language the committee recommends:

> As described in note_____, the financial statements of the Department of X are intended to present the financial position and results of operations and changes in financial position of proprietary and similar trust fund types of only that portion of the funds and account group of the State of Y that is attributable to the transactions of the Department of X.

A future issue of the *Journal of Accountancy* will contain a technical inquiry and answer on this subject. To get a paper that includes an in-depth discussion of this issue, send a self-addressed envelope to the Government Accounting and Auditing Committee. The address is: AICPA, Government Accounting and Auditing Committee, 1455 Pennsylvania Avenue, NW, Washington, DC 20004–1007.

REQUEST FOR ATTESTATION ENGAGEMENT QUESTIONS

The Auditing Standards Division requests questions from practitioners on unique attestation issues or engagements. Questions are invited on issues which relate to any attestation standard, or the appropriateness of use of attestation reports by third parties. Possible areas might include (but are not limited to):

- Whether attestation standards apply to particular circumstances.
- Whether certain client assertions are capable of evaluation against reasonable criteria.
- Reporting issues when scope problems or material uncertainties arise.
- Other attestation practice problems.

To allow adequate time for consideration, please send questions to the AICPA by May 21, 1988. The address is: AICPA, Auditing Standards Division, File 2160, 1211 Avenue of the Americas, New York, NY 10036–8775.

RECENT DIVISION PUBLICATIONS

In February 1988 the Auditing Standards Division issued "Responding to Requests for Reports on Matters Relating to Solvency," an interpretation of Statement on Standards for Attestation Engagements. (See the article on page 2.)

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